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ICPS newsletter

ICPS economists leave unaltered their forecast for 2002 economic growth

The next issue of the Quarterly Predictions has already been published by the International Centre for Policy Studies. ICPS economists leave unaltered their forecast for 4.5% growth of the Ukrainian economy in 2002. More rapid economic growth would be fueled by improved economic development of Ukraine's trading partners. Nevertheless, due to the inconsistent economic policy pursued by the government, and a sluggish investment dynamic given maximum utilisation of available capacities, ICPS experts offer a less optimistic estimation of economic development prospects in 2003–2004, that is, GDP will grow by 5% and 5.5%, respectively

Growth in Q2'02 is precarious

In Q2'02, Ukraine's economy evolved faster. With 3.8% growth in Q1'02, by the end of H1'02, GDP improved by 4.3%. Despite trade and agriculture developing the most rapidly, the key impetus to the economic growth in Ukraine was the processing industry.

The acceleration of economic growth in Q2'02 was complemented by deflation in the consumer market. A sudden downward price dynamic, along with inert nominal indicators, triggered the acceleration of real wages and, correspondingly, of household incomes.

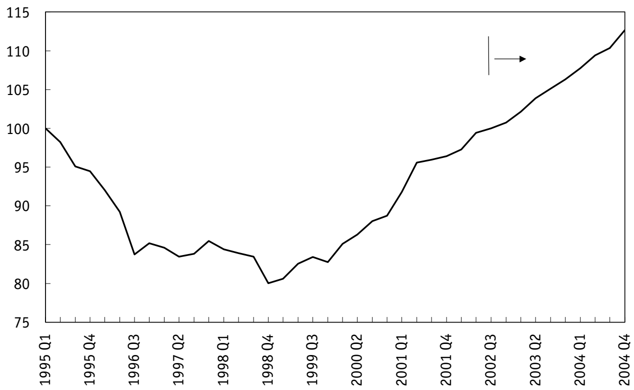
However, ICPS economists believe that the better results in Q2'02 do not necessarily mean better prospects for further development of the Ukrainian economy, since:

• Economic policy reform has stalled. Specifically, the following problems are still under consideration: (1) carrying out price-formation policy in the market for public utilities and transport services, where many providers are loss-making; (2) the need to modify the taxation system—existing proposals fail to reconcile the interests of taxpayers and tax agencies; and (3) the unresolved problem with VAT reimbursements to grain exporters on CPT and FOB terms;

• Despite a rapid GDP growth over three years and improved sovereign credit ratings, the inflow of foreign investment has not accelerated, which testifies to high estimated risks for foreign investors conducting business in Ukraine.

Real GDP

Index, seasonally adjusted, Q1'95=100



Source: State Statistics Committee;
calculations and forecast by Quarterly Predictions.

Coping with deflation

In H1'02, the Consumer Price Index (CPI) slid by 1.8%. On the one hand, the consumer deflation is the outcome of a noticeably expanded supply of goods and services—primarily of food products, as a result of growth in agriculture—under a stable hryvnia exchange rate. On the other hand, the deflation signals about a slowed dynamic of domestic demand. The adverse effect of deflation is that it reduces investment incentives (since the return on them diminishes) and discourages consumption (since in the future goods will cost less).

The estimated actual deflation over the past year has prompted the government agencies in charge of devising and implementing economic policy to make it more expansive. In this particular context, ICPS economists have reviewed the proposal for 3 billion UAH in long-term crediting to the banking system for investment projects of the NBU, brought forward by the Ministry of Economy and European Integration of Ukraine. In general, a budget deficit increase and its monetary financing might seem attractive. In this case, the government stimulates domestic demand with state expenditures, while higher growth of monetary aggregates will overcome the deflationary trend. However, ICPS experts warn against the overuse of such a policy, since:

• A weighty deflation factor is the non-monetary component related to productivity and the agricultural harvest. Apart from this, inflation was abruptly slowed down by unrevised tariffs for consumer services;

• The growth rate of industrial producer prices is higher than that of consumer prices;

• The increase of the budget deficit will mean accumulation of the state debt. If this is the case, the cost of its servicing may increase, since risks to its solvency may aggravate in the mid-term;

• Expansive policy is effected with a time lag. Earlier, when inflation was high, the average lag of the monetary policy was shorter. ICPS economists believe that now, with the rate being low, the lag gets longer, almost matching that of more developed countries.

ICPS experts leave unaltered their forecast for 4.5% growth of Ukraine's economy in 2002. However, ICPS economists have revised the dynamic of separate components: on the one hand, slower investment growth (6%); on the other hand, the forecast for net exports is now higher. In total, ICPS economists attribute their forecast minor increase in the GDP growth rate in H2'02 (compared to H1'02) to a better status of Ukraine's trading partners and the initiated easing of their protectionism measures. ICSP experts forecast that consumer inflation will jump to 5% by the end of 2002, in view of raised tariffs for public utilities, electricity, transport, and communications, increased producer prices, and higher inflationary expectations among households.

ICSP economists dampen down the forecast for 2003–2004

Whether Ukraine's economy will continue to develop depends on its capacity to increasingly penetrate international markets, as well as to satisfy the increasing needs of national consumers. In the mid-term, one of the key issues of foreign economic policy pursued by Ukraine's government will be accession to the World Trade Organisation (WTO), which, according to ICPS experts, will happen at the end of 2003. The previous issue of the *ICPS Newsletter* featured the factors of the current trade structure of Ukraine's foreign trade and possible implications for the Ukrainian economy ensuing from the WTO accession.

The problem of exhaustion of production capacities is getting more crucial in terms of development of national production of domestic goods and services. Over the first three years following the economic recovery, as a response to increased demand, enterprises intensified the capacity utilisation which was underused in the course of the transformation recession. ICPS economists believe that, nevertheless, enterprises can continue to expand production by investing in creating new production capacities, which requires more funds. Since domestic investment sources are limited, propping up a high GDP growth rate attracts more foreign direct investments. Nevertheless, ICPS experts have adjusted downwards their investment forecast for 2003–2004, in view of the risks of political instability and incoherent public policy, particularly in the privatisation and taxation areas.

Although tax reform in Ukraine has been the order of the day for many years, coherent mutually coordinated changes in regulation have not been introduced yet. The Verkhovna Rada of Ukraine rejected the government proposal to introduce changes in taxation, and intends to work out proposals for tax legislation with its own resources. However, until parties start to seek compromise regarding the comprehensive tax reform, there could be no hope for progress. ICPS economists assume that the government will reduce personal income tax rates starting in 2004.

Given these facts, ICPS experts have dampened their forecast for Ukraine's economic dynamic in 2003 and 2004. Ukraine's GDP will improve by 5% in 2003. The acceleration will be triggered mainly by continuing galvanisation of the international business activity, as well as recovered investment growth after the 2002 failure and an increased propensity to consume boosted by more optimistic expectations regarding long-term development prospects. In 2004, the GDP will pick up by 5.5%, following accelerated household consumption after lowered tax rates and a stimulating policy on the eve of the presidential elections.■

If you wish to receive the Quarterly Predictions Bulletin, please contact Yevhenia Yehorova, at tel. (38-044) 236-54-64 or via e-mail: marketing@icps.kiev.ua, or you can place an order via our web-page: www.icps.kiev.ua/ukr/subscription.html

Major indicators

	2001 (estimate)	2002 (forecast)	2003	2004
Economic activity				
GDP, *billions UAH*	201.3	221.6	253.6	286.3
Real GDP, *apc**	9.1	4.5	5.0	5.5
Real industrial output, *apc*	14.2	6.0	8.0	9.0
Real agricultural output, *apc*	10.0	2.4	6.8	5.8
FDI, *millions USD* (1)	769	700	800	900
Real household disposable income, *apc*	14.5	12.0	8.0	8.5
Real retail trade, *apc*	11.7	8.0	8.0	8.0
Prices				
Consumer price index, *apc*	6.1	5.0	5.5	6.5
Producer price index, *apc*	0.9	7.7	6.0	5.0
Labour market				
Population, *millions*	49.0	48.7	48.4	48.1
Real wages, *average apc*	20.9	12.0	7.0	8.5
Official unemployment rate, %	11.0	10.5	10.5	11.0
Foreign economic activity				
Exports of goods&services, *apc*	8.0	4.0	7.0	8.0
Imports of goods&services, *apc*	14.1	5.0	8.5	9.0
Current account balance, *% GDP*	3.7	3.4	2.3	1.4
Budget				
Revenues (consolidated), *% GDP* (2)	25.2	27.0	25.9	25.5
Balance (IMF methodology), *% GDP*	-1.8	-0.2	-0.2	-0.5
Financial indicators				
Monetary base, *apc*	37	31	32	31
M3, *apc*	42	32	33	34
NBU international reserves, *millions USD*	3095	4100	5185	5985
Official exchange rate (average annual), *UAH/USD*	5.37	5.35	5.50	5.65
Loan interest (average annual), *yearly %* (3)	32	25	22	20
International				
World GDP, *apc*	2.5	2.7	3.9	4.1
GDP of Ukraine's major trading partners (2/3 of exports), *apc*	2.7	3.3	3.9	4.4

** apc = annual percentage change*
*** aapc = average annual percentage change*

Notes:

(1) according to NBU;
(2) calculated by IMF methodology since 2001;
(3) commercial banks loans, UAH

Sources: State Statistics Committee, NBU, and Finance Ministry; calculations and forecast by Quarterly Predictions.

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